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Supreme Court of the United States

ADAM A. ADAMS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI AND BRIEF IN SUPPORT THEREOF.

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Petition for Writ of Certiorari.

Supreme Court of the United States

OCTOBER TERM, 1945.

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

To the Honorable The Supreme Court of the United States:

Your petitioner, Adam A. Adams, prays that a Writ of Certiorari issue to review the order of the United States Circuit Court of Appeals for the Third Circuit, entered after reargument before the Court *en banc*, affirming the order of the Tax Court of the United States, pursuant to which a deficiency in petitioner's income tax for the calendar year 1941 was found in the amount of $113,021.44.

A.

Summary and Short Statement of the Matter Involved.

1. The facts as found and considered by the Tax Court are as follows:

The petitioner, Adam A. Adams, is an individual, presently residing at 231 Elmwynd Drive, Orange, New Jersey. He filed an income tax return for the calendar year in question with the collector of internal revenue for the fifth dis-

trict of New Jersey (App. 32a; Par. 1 of Petition, admitted by Answer).

The Newark Theatre Building Corporation (hereinafter referred to as the Corporation) is a corporation of New Jersey (Petitioner's Exhibit 1). Prior to December 6, 1940, said Corporation had an authorized capital stock of 6,000 shares of common stock, each of the par value of $100.00 (Petitioner's Exhibits 1, 3). Of such authorized par value stock, there were issued and outstanding, at said date and until January 27, 1941, 5,914 shares, of which petitioner was the owner and holder of 5,903 shares (App. 10a, 11a, 30a).

On December 6, 1940, a plan of recapitalization was adopted by the stockholders of the Corporation to reduce the aggregate par value of the authorized capital stock from $600,000.00 to $295,700.00, to be divided into 5,914 shares of stock of no par value (or a stated value of $50 each), and to issue 6%, twenty-year debenture bonds, in the aggregate principal sum of $295,700.00 (Petitioner's Exhibit 2, App. 62a-68a, 11a). Said plan provided, furthermore, for the issuance by the Corporation of one no par value share and one $50.00 debenture bond in exchange for each $100.00 par value share of stock which it had outstanding (Petitioner's Exhibit 2, App. 62a-68a, 11a).

The plan to recapitalize was adopted for several reasons. Among such reasons were the savings in federal income and state franchise taxes to be effected thereby (App. 10a-11a, 26a, 35a). The Corporation accomplished the former by deducting interest payments on the debentures (App. 21a). The Corporation accomplished the latter by a reduction of its outstanding stock, resulting in an annual saving in excess of $400.00 (App. 10a, 30a). To be exact, it

has saved $413.98 each year and will so save in each year of its existence (App. 30a). The legal fees paid with respect to effecting the recapitalization amounted to $759.44 (App. 20a).

Another reason for the recapitalization was the Corporation's desire to refinance its indebtedness (App. 9a). Said indebtedness was in the form of a mortgage on the Corporation's properties, contracted at the time petitioner and his brother were doing business as a partnership (App. 9a, 32a). Both men had become individually and personally liable on the bond (App. 9a, 32a). Said liability continued subsequent to the severance of their incorporated interests and Peter Adams repeatedly demanded he be taken off the bond, he no longer having any interest in the Newark Theatre Building Corporation (App. 10a, 32a). Due to the maturity date of the mortgage, refinancing thereof became necessary and pressing (App. 19a, 33a). Repeated efforts on the part of the Corporation to have the mortgagee relinquish Peter Adams's personal liability failed (App. 10a, 32a), as did many attempts to negotiate a new loan (App. 10a). The Corporation, at the time of the proposed plan, concluded that it would be easier to finance a loan if it issued bonds which it could place as collateral, "rather than the common stock of the company which in itself nobody seemed to want to take as collateral" (App. 10a, 19a, 32a). To the end that the value of its property could be ascertained for purposes of negotiating such a loan (App. 60a), an investigation of its realty on Market Street, Newark, was made between December 15-30, 1940 and an appraisal was submitted as of January 1, 1941 (App. 40a). The appraiser was neither informed as to the reason therefor nor the purpose thereof (App. 40a, 60a).

In addition, the recapitalization was undertaken because Mr. Adams desired to give some bonds to members of his family (App. 21a, 33a).

The foregoing plan of recapitalization was carried out in exact accordance with its terms (App. 12a). Pursuant thereto, on January 27, 1941, petitioner surrendered to the Corporation his 5,903 shares, the shareholders of the other 11 outstanding certificates did likewise, and new certificates and debentures of the type called for by the plan were issued to them (App. 11a, 12a, Petitioner's Exhibits 4, 5, App. 69a, 70a-71a). The Corporation's capital stock account was written down from $591,400.00 to $295,700.00 (App. 18a), the balance was credited to debentures (App. 18a), and its certificate of incorporation was amended, pursuant to the plan of reorganization (Petitioner's Exhibit 6, App. 72a-78a). No entries or changes were made with respect to the surplus account (App. 18a, Petitioner's Exhibits 7, 8, App. 79a-82a). Nor was there any intent on the part of the Corporation to take anything out of surplus or to declare a dividend (App. 19a). And it was found as a fact by the Tax Court that: "The surplus account was not affected" (App. 86a, 98a).

The earnings and profits of the Corporation accumulated since February 28, 1913, and up to December 31, 1940, were $157,225.05, and up to December 31, 1941, were $164,874.47, of which $111,596 had been capitalized by stock dividends declared in prior years. (App. 13a, 27a, Petitioner's Ex. 7, App. 79a-80a). The accumulated earnings and profits of the corporation available for distribution on January 26, 1941, were not less than $164,514.82.

The debentures regularly earned and paid the interest due on them.

2. The facts established at the hearing of the instant cause, but with respect to which the Tax Court neglected and omitted to make findings, relate to petitioner's cost basis of his 5,903 shares and the fair value of the property received by him in exchange therefor. However, as hereinafter indicated, important federal questions of law which were raised before, and not passed upon by, the United States Circuit Court of Appeals for the Third Circuit with respect to subsidiary issues herein involved, turn upon such facts and would appear to make imperative a remand of the case to the Tax Court with instructions to make further findings of fact, if the Circuit Court is not reversed upon the principal issue herein involved.

The testimony at the hearing of the instant cause is clear that petitioner's 5,903 shares were acquired by him at various times prior to the reorganization, at an aggregate adjusted cost to him of $417,944.28 (App. 16a, 17a, 21a, 30a). Said cost basis had its roots in petitioner's initial investment in certain partnership assets (App. 14a, 22a, 27a, 28a) and subsequ[redacted] in successor corporations, all testimony with respect to which was minutely developed at the hearing (App. 14a-25a, inclusive).

The testimony is equally clear that the fair value of the property received in exchange by petitioner for his 5,903 shares of stock was $272,086.69 (App. 44a-58a, inclusive). Accordingly, petitioner realized a loss of $145,857.59 upon the exchange.

3. The case was tried in the Tax Court before Judge Kern, who made findings of fact and rendered an opinion (promulgated on April 26, 1945) in favor of the petitioner.

Subsequently, and pursuant to an order of Judge Murdock, dated May 1, 1945, the case was referred by him to the entire Court for review. Thereupon, the earlier decision was reversed by a divided court, the majority opinion being written by Judge Opper. Said opinion was promulgated on June 29, 1945. Judges Arundell, Smith, Black, Hill and Kern dissented. Two separate dissenting opinions were filed.

On September 6, 1945, petitioner filed with the Clerk of the Tax Court of the United States a petition for review by the United States Circuit Court of Appeals for the Third Circuit of the decision of the Tax Court. Said cause was argued before the Circuit Court of Appeals on February 7, 1946, before Judges Maris, Goodrich and O'Connell. On February 15, 1946, the Circuit Court, on its own motion, ordered the case restored to the argument list for re-argument before the court *en banc*. The case was re-argued on March 5, 1946 before Judges Biggs, Maris, Goodrich, McLaughlin and O'Connell. The opinion of the Circuit Court was filed on April 16, 1946. Judges Maris and Goodrich filed a dissenting opinion.

B.

Jurisdiction.

1. The date of the judgment of the Circuit Court of Appeals for the Third Circuit to be reviewed was April 16, 1946.

2. This petition was filed within three months of April 16, 1946.

3. The jurisdiction of the Court to issue the writ of certiorari herein prayed for is invoked under Judicial Code, Section 240(a), as amended by the Act of February 13, 1925, 43 Stat. 938 (U. S. C. A., Title 28, Section 347).

C.

Questions Presented.

The questions presented are:

1. Was an exchange of $100 par value shares of the Newark Theatre Building Corporation for new no par common stock and debenture bonds of the same corporation, pursuant to a plan of reorganization, an exchange upon which gain or loss is not recognized under Sections 112(b) and 112(g) of the Internal Revenue Code, or was such exchange equivalent to the distribution of a taxable dividend under Section 115(g)?* If the latter, what was the extent of such dividend?

2. In order that a recapitalization come within the statutory provisions providing for non-recognition of gain, must it appear that such recapitalization was adopted and carried out for a business purpose? If so, must such purpose be a corporate purpose as distinguished from a stockholder purpose?

3. Are not the purposes herein set forth business purposes of the corporation as well as of the stockholders?

4. In view of the fact that the corporation's surplus account was not affected in the economic or accounting

* All sections of the Internal Revenue Code herein referred to are set forth in the Addendum, attached hereto.

sense, could the recapitalization herein involved have resulted in a distribution "essentially equivalent to a taxable dividend"?

5. In view of the fact that the exchange herein resulted in a loss to petitioner if gain or loss is to be recognized, could said exchange have resulted in the distribution of a taxable dividend to him?

6. Did petitioner realize any income in the constitutional or statutory sense from the recapitalization?

7. In view of the fact that a loss occurred, did not petitioner actually overpay his tax?

D.

Reasons Relied Upon for Allowance of Writ.

1. The Circuit Court of Appeals for the Third Circuit, in holding that the recapitalization herein involved resulted in a distribution "essentially equivalent to a taxable dividend" in spite of the Tax Court's finding of fact that the corporation's surplus account was not affected, has reached a result in direct conflict with the prevailing authority established by the Circuit Court of Appeals for the First Circuit on the same matter. *Bass v. Commissioner*, 129 F(2d) 300 (C. C. A. 1st, 1942).

2. The Circuit Court of Appeals for the Third Circuit, in holding that a recapitalization within Sections 112(g) (1) (E) and 112(b) (3) of the Internal Revenue Code must have a corporate business purpose, is the first appellate tribunal to inject such a requirement into said sections. Whether said sections of the Internal Revenue Code require a corporate business purpose presents an important question of Federal law which has not been, but should be, settled by this Court.

3. The Circuit Court of Appeals for the Third Circuit, in holding that a recapitalization within Sections 112 (g) (1) (E) and 112 (b) (3) of the Internal Revenue Code must have a corporate business purpose, has decided a Federal question in a way which is an unwarranted extension of authority established by this Court. *Gregory* v. *Helvering*, 293 U. S. 465 (1935).

4. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, failed to pass upon the Federal questions of law heretofore raised by petitioner involving Sections 112 (b) (2), 112 (c) (1) and 112 (e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112 (b) (3), the exchange herein could not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss.

5. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, failed to pass upon the Federal questions of law heretofore raised by petitioner involving Sections 111, 112 (a) and 117 of the Internal Revenue Code. Under these sections, even if recognition of gain or loss upon the exchange was not precluded under Section 112 (b) (3) and even if said exchange was not a loss transaction under Sections 112 (b) (2), 112 (c) (1) and 112 (e), then said exchange was one upon which gain or loss was recognized, subject to treatment as a capital gain or loss, and the petitioner sustained a loss as a result thereof. This, in turn, resulted in an overpayment of tax by petitioner for the taxable year in question.

6. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court, has violated the

Sixteenth Amendment to the Constitution of the United States as well as Section 22 of the Internal Revenue Code, which lay down the concept of "income" in the constitutional and statutory sense, respectively, and has decided the Federal question of what is income in direct conflict with decisions of this Court: *Eisner* v. *Macomber*, 252 U. S. 189 (1920); *Strassburger* v. *Commissioner*, 318 U. S. 604 (1943); *Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

WHEREFORE, your petitioner prays that a writ of certiorari issue out of and under the seal of this Honorable Court, directed to the United States Circuit Court of Appeals for the Third Circuit, commanding the said Court to certify and send to this Court for its review and determination on a day certain to be therein designated, a full and complete transcript of the record and of all the proceedings of the said Circuit Court of Appeals, in the said case entitled in that court: Adam A. Adams *vs.* Commissioner of Internal Revenue, No. 9069, October Term, 1945, to the end that this case may be reviewed and determined by this Court as provided for by the statutes of the United States and that the judgment herein of the Circuit Court of Appeals be reversed by this Honorable Court, and for such other and further relief as to this Court may seem proper.

ADAM A. ADAMS.
By SYDNEY A. GUTKIN,
Attorney for and of Counsel with
Petitioner.

Supreme Court of the United States

OCTOBER TERM, 1945.

ADAM A. ADAMS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

Opinions of the Courts Below.

The original opinion of the Tax Court of the United States in this proceeding was promulgated on April 26, 1945. It is reported at 4 T. C. 1186 and is printed in the Appendix at page 83 a.

The superseding opinion of the Tax Court of the United States in this proceeding was promulgated on June 29, 1945. It is reported at 5 T. C. 351 and is printed in the Appendix at page 95 a.

The opinion of the United States Circuit Court of Appeals for the Third Circuit has not been officially reported at the time of the filing of this brief, but said opinion was

rendered on April 16, 1946 and is found in the Appendix at page 114a.

II.

Jurisdiction.

In the interests of brevity, the jurisdictional facts set out in Title B of the foregoing Petition will not be repeated here.

III.

Statement of the Case.

The basic facts are set forth in the foregoing petition. In the interests of brevity, the statement will not be repeated, although so far as may be necessary, further facts will be discussed in connection with the argument.

IV.

Specification of Errors.

1. The Circuit Court of Appeals for the Third Circuit erred in holding that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend where the Tax Court found as a fact that the corporation's surplus account was not affected.

2. The Circuit Court of Appeals for the Third Circuit erred in holding that a recapitalization within Sections

112(g)(1)(E) and 112(b)(3) of the Internal Revenue Code must have a corporate business purpose.

3. The Circuit Court of Appeals for the Third Circuit erred in failing to hold that the recapitalization herein had a corporate business purpose.

4. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 112(h)(2), 112(c)(1), and 112(e) of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

5. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to consider the Federal questions of law involved in Sections 111, 112(a) and 117 of the Internal Revenue Code, all of which were raised in petitioner's briefs and oral argument, and in failing to hold that there was no taxable income to be recognized upon the exchange herein.

6. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in holding that the petitioner realized income.

7. The Circuit Court of Appeals for the Third Circuit, in affirming the decision of the Tax Court of the United States, erred in failing to find that the petitioner sustained a loss.

V.

THE ARGUMENT.

POINT A.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein involved resulted in a distribution essentially equivalent to the distribution of a taxable dividend in spite of the Tax Court's finding of fact that the Corporation's surplus account was not affected conflicts with the prevailing authority established by the United States Circuit Court of Appeals for the First Circuit on the same matter. In fact, the Tax Court admittedly flouted the First Circuit Court's precedent in arriving at its decision in the instant case.

Under Section 115 (a) of the Internal Revenue Code a dividend is any *distribution* by a corporation to its shareholders, whether in money or property, either out of *accumulated earnings and profits or earnings and profits of the taxable year.* The facts herein clearly indicate there was no *intent on the part of the Corporation to declare a dividend, that no entries or changes were made with respect to the surplus account, that there was no "distribution" of money or other property, and that petitioner's aggregate wealth was in no way increased.* Moreover, *the Tax Court found as a fact that the surplus account was not affected.*

It is a fundamental accounting principle that dividends, if declared and paid, must come from some surplus account,

whether it be earned and available or otherwise. It is a fundamental principle of tax and corporation law that every dividend involves, in the first instance, a segregation out of surplus account of a definite portion of the corporate earnings and profits available for dividends, thereby making such profits unavailable for future distribution at the discretion of the directors. It would be a contradiction in terms to say that there has been a "distribution" out of "earnings or profits" when such earnings and profits have been left intact and available for dividend distributions in the future. Aside from the constancy of the Corporation's surplus account in the accounting sense, there was, in the economic sense, as much available for future dividend distributions subsequent to the exchange as prior thereto. It is submitted that there could not have been any such distribution of earnings and profits as is envisaged by Sections 115 (a) or 115 (g) of the Code.

The foregoing principles have been forcefully enunciated by the Circuit Court of Appeals for the First Circuit in *Bass* v. *Commissioner*, 129 F(2d) 300(1942) in its reversal of the decision of the Board of Tax Appeals in *Edith B. Bass*, 45 B. T. A. 1117 (1941), and there can be no doubt that had the case at bar arisen in the First Circuit, the result herein would have been different from that reached by the Third Circuit.

The Tax Court recognized the precedent set by the First Circuit Court, but chose to ignore appellate authority with a statement that with "the greatest deference, however, we remain of the opinion that the decision of the Board of Tax Appeals in that case was correct, and we feel obliged to adhere to it rather than to follow the reason-

ing of the opinion of reversal". The majority of the Tax Court cited in this connection and relied upon *Doerschuck* v. *United States*, 274 Fed. 739 (D. C. E. D. N. Y., 1921) and *Peabody* v. *Eisner*, 247 U. S. 347, 38 S. Ct. 546 (1918), neither of which is applicable herein. In the *Doerschuck* case, a corporation voted an issue of $738,000.00 of debenture bonds *from its surplus account*, and said bonds came into the hands of plaintiffs in the proportion of their stockholdings. There was no reorganization involved. The Court found that the plaintiffs received an actual payment of profits which the company wished to distribute as earnings to its stockholders. In the *Peabody* case, there was a *declaration of a dividend* by a corporation and the payment of such dividend by cash and stock held by it in a second corporation. Thus, there was a dividend *distribution in specie*. No reorganization was involved. Neither of these cases stands for anything more than the general proposition that a dividend distribution may take the form of property other than money. Obviously, said cases have no bearing on the issue before this Court.

Nor has the conflict of opinion between the Circuit Courts of Appeals for the First and Third Circuits in any way been alleviated or resolved by the decisions of this Court which the Third Circuit cited in support of the collateral proposition that corporate accounting concepts do not control tax incidents, eg. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283 (1945); *Commissioner* v. *Wheeler*, 324 U. S. 542 (1945); *Helvering* v. *Gowran*, 302 U. S. 238 (1937). Petitioner concedes that mere bookkeeping entries should not be conclusive with respect to tax consequences, but submits that none of the cases cited by the Third Circuit

Court of Appeals furnish any precedent for its holding herein that the exchange amounted to a distribution essentially equivalent to a dividend. In the *Bedford* case, the taxpayer, in connection with a recapitalization, exchanged his preferred stock for other preferred stock and common stock of the same corporation, *and cash*. Admittedly, the recapitalization was a tax-free exchange, the sole issue being whether the cash distribution was taxable as a dividend or a capital gain. In the *Gowran* case, a *dividend had been declared* on common stock payable in preferred stock. The question there concerned the taxation as income of the preferred stock dividend and the proceeds received on the sale thereof. In the *Wheeler* case, the issue involved the proper basis to be used to compute, pursuant to Section 112(b)(7) of the Revenue Act of 1938, the amount of "earnings and profits" distributed as liquidating dividends. The question did not concern whether there *was* a distribution, but rather the amount thereof, which, in turn, depended upon whether certain gain included in "earnings and profits" was properly computed by using as the basis of the assets in question the cost to the transferors rather than the higher market value when acquired.

The Third Circuit's citation of *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), in support of the proposition that under Section 115 (b) every distribution is made out of earnings or profits to the extent thereof is likewise considered inappropriate here. Petitioner does not deny the rule as stated but points to its inapplicability in the instant case. Section 115 (b) of the Code attributes a source to distributions *when distributions are made*, and when such is

the case, they are deemed to be made out of earnings or profits to the extent thereof. "Section 115 (b) does not, however, prescribe the criteria for determining when a distribution has taken place, as distinguished from an exchange, which is governed by Section 112", *Bass v. Commissioner, supra*, page 308, nor does it convert "what is not income into income." *Leland v. Commissioner*, 50 F (2d) 523, 525 (C. C. A. 1st, 1931).

It is submitted that there exists a real, basic cleavage between the First and Third Circuit Courts of Appeals with respect to the possibility of having a dividend, in the economic sense, distributed to a stockholder of a corporation, or of having such a distribution which is essentially equivalent to the distribution of a dividend, where surplus, in the economic sense, has not been affected.

To resolve this conflict and to avoid wasteful litigation which is sure to arise in the future with respect to the issue here presented, petitioner emphasizes the need for a definitive pronouncement by this Court and therefore prays that the Writ herein sought be granted.

POINT B.

The holding of the Circuit Court of Appeals for the Third Circuit that the recapitalization herein must have a corporate business purpose to be within Sections 112 (g) (1) (E) and 112 (b) (3) is interstitial legislation injecting a new requirement into the statute. Said requirement is an unwarranted extension of authority established by this Court in *Gregory* v. *Helvering*, 293 U. S. 465 (1935).

The Circuit Court of Appeals for the Third Circuit is the first appellate tribunal, so far as can be ascertained, to inject into Sections 112(g) (1) (E) and 112(b) (3) the requirement that a recapitalization, to be within the non-recognition provisions, must have a corporate business purpose. *Bazley* v. *Commissioner*, F. (2d) , Dkt. No. 8947, Opinion filed 4/16/46.

There appears to be no legislative or judicial precedent for such requirement. There is nothing in the plain language of the statute which requires a corporate business purpose. There is nothing in the legislative history of the foregoing sections which indicates that the enactors thereof intended that such purpose should be prerequisite to the invocation and operation of the sections. In fact, the whole doctrine is a fiction of the Tax Court, having been brought to light in recapitalization cases for the first time in *Louis Wolfhouse, Jr.*, 3 T. C. 363 (1944).

Inasmuch as the question has been excellently stated and discussed by Judges Maris and Goodrich in their dissenting opinion in the *Bazley* case, which was likewise

adopted by them with respect to the instant case, it is in great measure now quoted:

> "The critical question in this case is, we think, one of law and one upon which this Court has an obligation to exercise its own judgment when the decision of the Tax Court is brought here for review. That question is whether a corporate reorganization, in order to be tax free, must be one conducted for a 'corporate business purpose' of the corporation as distinguished from serving a proper business interest of the shareholders.
>
> "That this question is squarely presented there can be no doubt. * * * We accept the Tax Court's findings of fact. We also, now that we understand we are so to do, accept its conclusion when it applies its facts to a correct rule of law regardless of whether we, in a particular instance, would have reached the same conclusion or not. But if we believe the legal criterion used by the Tax Court is incorrect it is our duty so to say and to send the case back for appropriate proceedings under the application of what we deem the correct criterion.
>
> "We think that the criterion here making a distinction between 'corporate' and 'shareholder' purpose is incorrect. The foundation for it is supposed to be Gregory *v.* Helvering, 293 U. S. 465 (1935). That case involved the formation of a dummy corporation which did no business otherwise than to participate in a transfer which the taxpayer was seeking to effect without tax liability. What we had was a sale masquerading as a reorganization. The court struck through the sham.
>
> "To expand that decision into a rule of law such as is now contended for is to push it beyond anything which we think the court could have had in

mind. Nor do we think the expansion is one which a reasonable growth beyond Gregory *v.* Helvering would call for. We have long since passed the place in our thinking where we view the corporation as 'an artificial being, invisible, intangible and existing only in contemplation of law'. We think of it as a device that shareholders use to carry on their business as a group. A corporation does not have purposes apart from its shareholders. Shareholders, of course, may have conflicting interests among themselves with regard to the conduct of their common enterprise. They may fight with each other, perhaps, in order to elect A instead of B to the directorship of their company. And, of course, aside from their interest in the common enterprise, called their corporation, they have interests as varied as the hopes and desires of human beings. But when we talk about the interest of shareholders in connection with the business enterprise and have a finding of fact that such and such a thing was done and that it was to the shareholders' business advantage, speaking of them as a group, we do not find substance in a distinction between the business advantages of the shareholders with respect to the corporation or the business advantages of the corporation itself.

Furthermore, this very thing concerned with here, reorganization, is a matter in which shareholders directly participate. The day to day business of the corporation is done by its officers, directors, employees. But a realignment of the interests in the enterprise through reorganization must come, under every corporation law we know of, through vote of the shareholders. In such circumstances it is as a practical matter impossible to separate as to the very transaction involved a 'shareholder's' from a 'corporate' interest.

"We think the distinction attempted coming, as it does, quite a number of years after Gregory *v.* Helvering, is one not established by that decision, the statute, nor the regulations. If reorganization provisions contain too many avenues of escape for taxes which ought to be collected the Congress can close those avenues by appropriate legislation which can be so framed and defined as to leave the way clear to what it deems are business transactions in which no gain or loss should be recognized. We do not think it should be by judicial decision which establishes the exceedingly vague criterion as to whether a given transaction was to the interest of the shareholder as distinguished from the interest of the corporation in which he holds shares of stock.

"The gloss here sought to be placed upon those provisions of Section 112 of the Internal Revenue Code which render nontaxable the exchange of certain securities in connection with corporate reorganizations, can only be justified upon the assumption that all reorganizations which are put through by stockholders solely to promote their own business purposes must necessarily involve the motive of tax avoidance. Only upon this assumption can the principle of Gregory *v.* Helvering be applicable. But this assumption is quite unsound as the facts of the case before us demonstrate. And even clearer cases can readily be brought to mind. Suppose a case in which the common shareholders arrange for the reclassification of a part of their holdings as non-voting stock in order that they may sell it or give it away without endangering their voting control. This would be a perfectly proper business purpose of the stockholders involving not a trace of tax avoidance but it would not benefit the business of the corporation as such. We do not think that there

is any authority for the proposition that such a recapitalization would not be within both the letter and the spirit of Section 112.".

It is submitted that should the doctrine of the corporate business purpose be allowed to continue in its present form, rules of law will be supplanted by rules of men. The Tax Court will virtually go into business, and substitute its subjective judgment, based on hindsight, for objective rules of law, in the determination of what is or is not a corporate business purpose. The effect upon business enterprise in the country will be tragic.

In view of the importance of the question to the bench, the bar, and taxpayers all over the country, and because it has been presented for the first time by an appellate tribunal divided within itself, petitioner prays that the Writ herein sought be granted so that this Court may articulate a definitive rule with respect thereto.

POINT C.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 112(b)(2), 112(c)(1) and 112(e) of the Internal Revenue Code. Under these sections, even if the recognition of gain or loss was not precluded under Section 112(b)(3), the exchange herein did not result in the distribution of a taxable dividend inasmuch as the transaction gave rise to a loss.

At the initial argument and upon re-argument before the Third Circuit Court as well as in his briefs, petitioner submitted that if it was concluded that the recognition of gain or loss with respect to the exchange herein involved was not precluded by the application of Section 112(b)(3), then, no gain or loss was to be recognized because of the operation of Section 112(b)(2), 112(c)(1) and 112(e) of the Code.

In the instant case, common stock in a corporation was exchanged for common stock and bonds in the same corporation. Were it not for the bonds, said exchange would fall completely within Section 112(b)(2), which provides that no gain or loss shall be recognized upon the exchange of common stock *solely* for common stock in the same corporation. However, where other property—that is, "boot"—is given in addition to stock, Sections 112(c)(1) and 112(e) become important.

Under Section 112(c)(1), if an exchange would be within Section 112(b)(2), precluding recognition of gain or loss, except for the fact that other property is given, then the *gain* to the recipient shall be recognized, but in an amount not in excess of the fair market value of such other property. Inasmuch as Section 112(c) concerns itself exclusively with the case where the fair value of the stock and boot exceed the basis of the stock surrendered in exchange therefor, it is accordingly inapplicable to the exchange herein, *which resulted in a loss.*

It should be noted that the undisputed facts herein show that the cost basis to the petitioner of his shares exceeded the fair value of the assets received by him in exchange therefor, resulting in a loss to him. The Tax Court, however, made no findings of fact with respect to such loss. We fail to perceive why it did not.

Having resulted in a loss, the exchange would be governed by Section 112(e). This section provides that if an exchange would be within Section 112(b) if it were not for the boot, and if the exchange results in a loss, such loss is not to be recognized, even though the transaction involves boot.

It is clear therefore, that even if the Third Circuit Court is correct in its conclusion that the recognition of gain or loss is not precluded by Section 112(b)(3), the application of Sections 112(b)(2) and 112(e) precludes the recognition of loss and compels the very result for which petitioner contends. The Court's failure to consider the problems inherent in the latter sections has greatly prejudiced petitioner's position herein and has resulted in grave in-

justice to him. The inequity of having a distribution taxed to him as a dividend when the transaction resulted in a loss is manifest. Accordingly, petitioner prays for the issuance of the Writ so that this Court may give proper consideration to said sections of the Code.

POINT D.

The holding of the Third Circuit Court of Appeals, affirming the decision of the Tax Court, fails to take cognizance of, or pass upon, the federal questions of law heretofore raised by petitioner involving Sections 111, 112(a) and 117 of the Internal Revenue Code. Under these sections, even if the exchange was one upon which gain or loss was recognized, the petitioner sustained a loss as a result thereof. Accordingly, petitioner overpaid his tax for the year 1941.

At the initial argument and upon re-argument before the Third Circuit Court, as well as in his briefs, petitioner submitted that the exchange of the Corporation's par value stock for new stock and debentures, of necessity, had to fall within one of three spheres: either if was (1) a tax-free reorganization within Sections 112(b)(3) and 112(g)(1)(E), upon which gain or loss is not recognized; or (2) it is a boot transaction upon which there is loss, said loss not being recognized, pursuant to Sections 112(b)(2) and 112(c), as contended under Point C; or (3) it is an exchange upon which gain or loss is recognized, subject to treatment as a capital gain or loss, pursuant to Sections 111, 112(a) and 117 of the Code.

Petitioner argued before the Circuit Court, and now reiterates, that if it is found that the exchange herein constituted an exchange requiring the computation of the realized gain or loss under Section 111; then the extent to which such "realized" gain or loss is to be "recognized" is determined by Section 112 and the extent to which such "recognized" gain or loss is to be taxed is determined by Section 117.

If, therefore, the recapitalization herein falls within the third category enumerated above, petitioner submits that he sustained a loss therefrom in the amount of $145,857.59, which is deductible as a long-term capital loss. Accordingly, petitioner overpaid his tax in 1941 by approximately $20,000.00.

It is not deemed necessary to repeat at length what appears in the Record and with respect to which the Tax Court made no findings of fact. With respect to the cost basis of petitioner's stock, this has been shown to be $417,944.28. The total fair value of the properties received by petitioner upon the exchange herein, appraised from a reproduction and replacement standpoint, was in the amount of $469,837.00. The total fair value of said properties appraised on the basis of capitalization of gross rental, was in the amount of $515,284.00. The petitioner has deemed it fair to average the valuations for the properties by dividing the total thereof, $985,121.00, by two, thereby deriving the quotient of $492,560.00. This last figure represents the fair value of the two parcels of real estate as of the time of the recapitalization.

The other assets of the Corporation, as per its Balance Sheet as at December 31, 1940, were in the amount of $84,923.49. The total assets were therefore in the amount of $577,433.49.

From said total assets are to be deducted mortgages payable on said parcels of realty in the amount of $291,250.00, in addition to other liabilities in the amount of $14,146.80 or a total of $305,396.80.

The difference between the total assets and total liabilities represents the net value of the Corporation's assets on recapitalization. This figure is $272,086.69.

Since the cost basis of petitioner's stock has been established at $417,944.28, and the fair value of the property received in exchange therefor has been shown to be $272,086.69, the loss to petitioner is the differential, or $145,857.59.

The equity, accuracy and inevitability of this result can be more fully appreciated after reference to Section 115(c) of the Code, which expressly provides that the complete liquidation of a corporation shall be regarded, as to stockholders, as an *exchange* of their stock for the assets of the corporation, and that gain or loss represented by the difference between the value of the assets received and the basis of their stock upon such exchange is to be determined under Section 111, recognized only to the extent provided in Section 112, and taxed at the capital gain rates provided by Section 117.

Petitioner, as the dominant stockholder, could have liquidated the company, thereby securing all its assets, and could have sustained and deducted a loss (and escaped

all tax) on the transaction by exchanging assets of a greater cost than the value attributable to the assets received. He could then have conveyed the assets to a new corporation in exchange for precisely the stock and debentures which he received in the instant recapitalization, and would then have held stock and bonds on the basis of their combined value. He would have been liable for no further tax on their sale at such value or their redemption.

As it is, the petitioner has done no more than to postpone the recognition of a loss until the actual sale or exchange of the bonds.

However, should this Court find that the exchange was one upon which gain or loss is recognized, petitioner accordingly submits that the instant cause should be remanded to the Tax Court for further findings with respect to the loss in the amount of $145,857.59, and for a determination regarding petitioner's overpayment of tax.

The failure of the Third Circuit Court to consider the problems inherent in Sections 111, 112(a) and 117 has greatly prejudiced petitioner's position herein, and petitioner accordingly prays for the issuance of the Writ so that this Court may give the proper consideration thereto.

POINT E.

The holding of the Circuit Court of Appeals for the Third Circuit, affirming the decision of the Tax Court, violates the Sixteenth Amendment to the Constitution of the United States, Section 22 of the Internal Revenue Code, and decisions of this Court.

The Sixteenth Amendment to the Constitution of the United States invests Congress with the power to lay and collect taxes on "incomes", from whatever source derived, without apportionment among the several States and without regard to any census or enumeration. Section 22 of the Internal Revenue Code, and the applicable regulations, define income to include all gains derived from capital, from labor, or from a combination of both. Both the Constitution and the statute require that there must be a realization of income, before tax incidents with respect thereto may ensue.

There have been suggestions in some cases that bonds issued in connection with a recapitalization, allegedly without business purpose, are not to be treated as bonds but are to be treated in the same manner as the stock given up in exchange therefor. *Commissioner* v. *Kelly Co.*, 146 F. (2d) 466 (C. C. A. 7th, 1944), rev'd. on another ground, 66 S. Ct. 299 (1946). If this is so, there can be no realization of income herein in either the statutory or constitutional sense if the Commissioner's contention is correct that no corporate business purpose was served by the recapitalization in question.

If what was issued by the Corporation was stock and not bonds, then nothing more was accomplished than a proliferation of capital, sans taxable consequences. *Eisner* v. *Macomber*, 252 U. S. 189 (1920); *Strassburger* v. *Commissioner*, 318 U. S. 604 (1943); *Helvering* v. *Griffiths*, 318 U. S. 371 (1943).

Accordingly, the bonds do not constitute taxable income and the Third Circuit Court's holding to the contrary is in error.

In addition, it is submitted that since there was a loss in fact incurred upon the transactions, it would be unconstitutional as well as unconscionable to tax petitioner on such loss.

Conclusion.

For the reasons stated in the petition and in this brief, it is respectfully submitted that the application for a Writ of Certiorari be granted.

Respectfully submitted:

SYDNEY A. GUTKIN,
Attorney For and Of Counsel
with Petitioner.

David Beck,
On The Brief.

ADDENDUM.

Constitution and Statute Involved.

CONSTITUTION OF THE UNITED STATES:

Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

INTERNAL REVENUE CODE:

SECTION 22—Gross Income—

(a) General Definition—"Gross income" includes, gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

SECTION 111—Determination of Amount of, and Recognition of, Gain or Loss—

(a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * * and the loss shall be the excess of the adjusted basis * * * over the amount realized.

(c) Recognition of Gain or Loss—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

SECTION 112—Recognition of Gain or Loss—

(a) General Rule—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) Exchanges Solely in Kind—

(2) Stock for stock of same corporation—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) Stock for stock on reorganization—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(c) Gain from Exchanges not Solely in Kind—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by

such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from Exchanges Not Solely in Kind—If an exchange would be within the provisions of subsection (b) (1) to (5), inclusive, * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(g) Definition of Reorganization—As used in this section (other than subsection (b) (10) and subsection (1)) and in section 113 (other than subsection (a) (22)).—

(1) The term "reorganization" means * * *

(E) a recapitalization * * *.

SECTION 115—Distributions by Corporations—

(a) Definition of Dividend—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) Source of Distributions—For the purposes of this chapter, every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

(c) Distributions in Liquidation—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112.

(g) Redemption of Stock—If a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

SECTION 117—Capital Gains and Losses—

(b) Percentage Taken Into Account—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income.

* * * 50 per centum if the capital asset has been held for more than 6 months. * * *